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Mandatory pension insurance: risks and benefits of the proposed changes

Pension reform is one of the main aspects of restructuring the social security system in Ukraine. The current pension system does not meet its major goal of protecting the elderly from poverty. This system is unfair and has no future, because there is no reliable connection between present savings and future pension benefits. Improving the system of mandatory state insurance is an important task of pension reform. As part of the Evaluating the Consequences of New Pension Legislation in Ukraine project, ICPS jointly with PADCO studied the draft law "On mandatory state pension insurance" from the view of proven guarantees of earned benefits to all citizens and the possibility of safe and effective means through which working people can save money for their retirement

Why is the current system ineffective?

Ukraine's current pension system is ineffective. This element of social policy fails to meet requirements which are a prerequisite for fulfilling the main function of the so-called "solidary system", i.e., protecting the elderly from poverty:

· it must provide adequate minimum benefits relative to the poverty level;

· it must provide reasonable benefits relative to the contributions people pay during their working life;

· the system must be fiscally sustainable in the short and long-term (although the current system is fiscally solvent, it would not be solvent if reasonable benefits were paid);

· the system should be administrated effectively—both in terms of collecting and distributing benefits and in minimising waste, fraud, and abuse;

· a sustainable pension system must be supported by an adequate legal framework and not require frequent amendments.

By international standards, Ukraine provides pensions at a very low age. Low retirement ages hurt the solidary pension system: citizens make contributions for shorter periods of time, and they receive benefit payments for a longer period of time.

The Ukrainian economy cannot afford to offer privileged pensions to so many members of its workforce. Currently, privileged pensioners have higher than average pensions and are retired at an earlier age. It leads to an inequitable benefit distribution since everyone contributes the same percent of their wages to the pension fund, but some workers get vastly better benefits. Another feature of the current pension system is that higher-paid workers receive a disproportionately small pension compared to the amount they contribute.

The system of "labour books" encourages fraud or falsification of work credits. Employees can leave their books with employers and receive work credits, without actually contributing to the Pension Fund. In addition, average monthly earnings used to calculate benefits are based only on the last two years' wages. In order to give employees eligibility for higher benefits, employers often raise workers' wages in the last two years.

The Pension Fund is, primarily, an

Last Week

Workshop on writing in the government. A workshop on government communication was held as part of the Economic Forecasting and Modelling in Ukraine project at ICPS on February 3. Mr. Michael Sperber, representing the Conference Board of Canada, has twenty years' experience of work in the Canadian government. He presented ideas on how to improve quality of government documents to experts of the Ministry of the Economy, the Ministry of Finance, and the National Bank of Ukraine.

When a government analyst drafts a document, he/she should answer four important questions:

· what is the topic (what you will address and what you will not address);

· who is the target audience (director, minister, colleagues—be conscious of what value you are bringing to each);

· what is the value of the document (requiring or recommending an action or decision, assistance for deeper understanding of an issue);

· what are the principal takeaways (what you want readers to remember from the document).

The document should be structured to focus on the last point. The principle takeaway should be supported by several key ideas, strengthened by arguments. To reach maximum effect, the author should sequence this information in order to make the most sense to readers.

Mr. Sperber provided workshop participants with hints about Canadian models of writing memos to management, and requirements for drafting ministry memoranda to the Cabinet of Ministers.

If you wish to receive the workshop notes (Ukrainian or English), please contact Oleksiy Blinov, ICPS marketing office, tel. (380-44) 463-3737, e-mail: marketing@icps.kiev.ua, or Oksana Remiga, project coordinator, e-mail: ORemiga@icps.kiev.ua.

An initial working macroeconomic model of Ukraine is ready. An initial working macroeconomic model of Ukraine, developed in the framework of the Economic Forecasting and Modelling in Ukraine project, was presented at ICPS on February 5. The presented materials are the result of six months' work of all participants of the project: experts of the Ministry of Economy, Ministry of Finance, National Bank of Ukraine, advisors of the Conference Board of Canada, and economists of the International Centre for Policy Studies.

The model includes the following blocks: real aggregate demand, aggregate support, income, government revenues and debt, financial markets, prices, input-output, and employment. This model is a theoretical variant. The next stage of the project is data collection and model correction according to this data.

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insurance fund. People pay in while they are working and expect benefits when they retire. *However, currently the Pension Fund is forced to use pension contributions to pay social security benefits to people who never worked, or who have worked for such short periods of time, that their pension benefits are scanty.* These people receive social pensions (if they have no work credits) or targeted assistance payments (if they have a few years of service credits or if their wages prior to retirement were very small). This practice contradicts insurance principles and undermines the pension insurance system.

Will the mandatory savings system be able to improve the situation?

In response to these problems, the government has already made certain changes in order to increase the effectiveness of the current solidary system. Social security deductions will be transferred directly to the State Budget between now and the end of 2001. Also, a personified account system has been established to create individual records of wages, contributions, and service credits for all workers. These changes alone are important but not sufficient to solve the main problem of the current pension system. Consequently, the government has proposed to introduce a mandatory individual savings system in the draft law "On mandatory state pension insurance". Contrarily to the solidary system, where the government allocates all contributions to current benefit payments, a new system will foresee records of contributions in individual savings accounts and their investment at financial market.

The main arguments for creating mandatory individual savings system are the following:

· fluctuations caused by demographic changes are smoothed over time;

· there is a chance to increase system effectiveness through giving private companies some responsibilities for collecting pension revenues, investing reserves, and distributing pension benefits;

· people are forced to set aside money during their working lives for their old age;

· the influence of short-run political considerations on the pension system is reduced;

· there is an incentive to increase savings, which are then invested in the economy and promote its growth.

Introduction of the mandatory individual savings system in Ukraine will be effective only under the following conditions:

· *economic growth.* The economy should be strong enough to generate sufficient revenues to the Pension Fund, to allow some revenues to be diverted to the new mandatory savings system while permitting the Pension Fund to continue paying for the solidary system;

· *finalisation of the system of personified reporting.* If the record-keeping system is not functioning properly, then there is no way to be sure contributions are properly allocated between the solidary and savings systems, and among contributors;

· *developing a proper legal and administrative infrastructure for regulating and managing Pension Fund activities.* The sharp surge of funds that will have to be invested demands that such an infrastructure is already working. To set it up at the same time as the mandatory savings accounts would guarantee a large financial catastrophe.

· *the public has been fully informed about all aspects of the mandatory individual savings system.* The introduction of this system necessarily involves the transfer of risks from the government to future pensioners. For example, if financial markets collapse, then people retiring at the time of the collapse will find their accumulated balances smaller because of the reduction in value of financial assets.

The Evaluating the Consequences of New Pension Legislation in Ukraine project was carried out jointly by ICPS and the Canada-Ukraine Legislative Co-operation Project, with funding from the Canadian International Development Agency. The project consists of three parts: (i) analysing the impact of the draft law "On mandatory state pension insurance" on the financial state of the pension system; (ii) analysing the impact of the draft law of "On mandatory state pension insurance" on the economy; and (iii) analysing the consequences of implementation of the draft law "On non-government pension funds". The complete report on the research results will be published in the nearest months in the ICPS Policy Studies journal.